



Department  
for Environment  
Food & Rural Affairs

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# **Consultation on the government's charging guidance to Ofwat**

## **Summary of responses**

**November 2015**



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## A. Introduction

The Water Act 2014 introduced reforms which will help achieve the government's ambitions for the water sector. These include legislative changes which will allow a new competitive market for retail services to non-household customers to open in April 2017. It will also allow increased competition in the upstream market which will take place after 2019. These changes are designed to bring benefits to customers, water companies, investors and the environment.

Alongside these reforms, the Water Act 2014 also includes a revised framework for the regulation of water companies' charges. This new framework creates powers for Ofwat to issue binding Charging Rules for the industry and requires the government to issue Charging Guidance to Ofwat. The purpose of the government's Charging Guidance is to set the policy framework within which Ofwat must operate and ensure that water charges are in line with the government's objectives.

The government ran a public consultation on the proposed Charging Guidance to Ofwat between 9<sup>th</sup> July 2015 and 6<sup>th</sup> August 2015. The aim of this was to gain views from interested parties about the content of the draft guidance. The draft guidance set out four overarching policy objectives for water charges. These were:

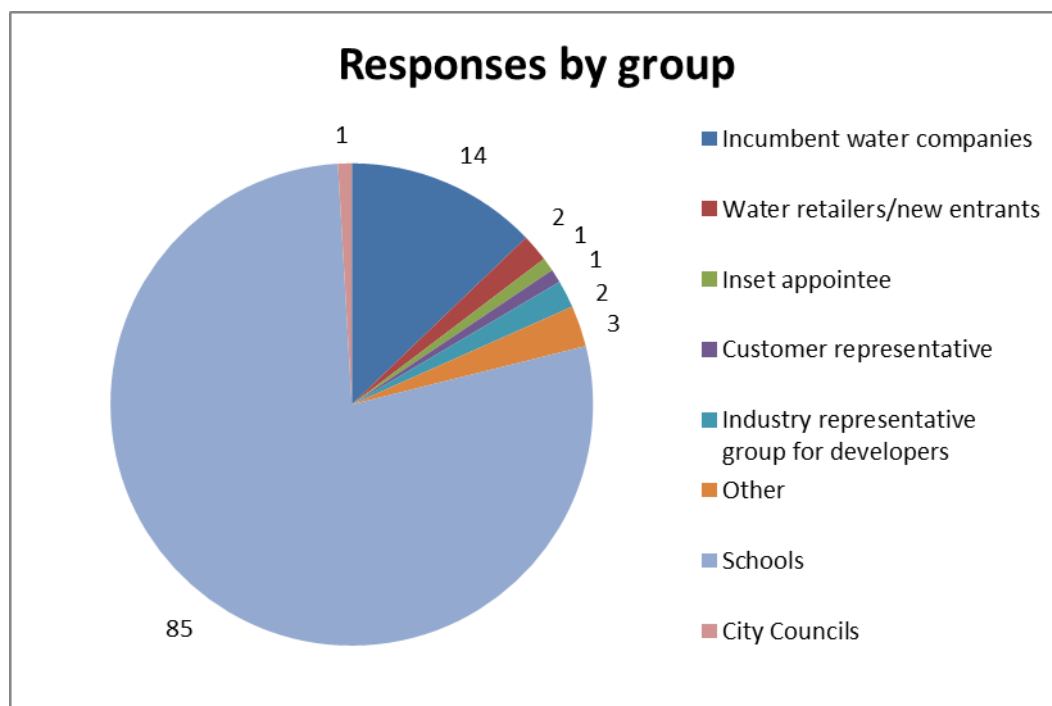
- fairness and affordability,
- environmental protection,
- stability and predictability,
- transparency and customer focused service.

It then outlined how these objectives should be achieved in all of the main charging regimes:

- household charges,
- non-household charges,
- charges in the retail market,
- charges in upstream markets; and
- charges for developers.

A range of different groups responded to the consultation (see figure 1 below). A number of responses were submitted by schools and other public organisations in the North West as part of a campaign. This campaign focused on surface water drainage charging and was relevant to the consultation question 5 which relates to charges for non-household customers.

Figure 1: number of responses to the consultation by group



## Summary

The consultation document asked 9 questions to gain views on the different parts of the guidance. Overall there was a good level of support for the government's policy aims set out and there was consensus that all the overarching objectives were appropriate. One water company's response said that they were content with the guidance as it stands and no changes were necessary.

There were also suggestions about how the guidance could be improved and these were made on a wide range of different issues. Some of the main themes related to: surface water drainage charges, the need for charging information to be appropriate and useful to customers, cost reflectivity; and charges in the new retail market due to open in April 2017.

We have carefully considered the points made in all consultation responses received and have summarized our views on these in the government response in section C of this document. We have also made several amendments to the detail of the final Charging Guidance as a result of the points made to us.

## Next steps

The final Charging Guidance to Ofwat will now be laid in Parliament for a period of 40 days. If at the end of 40 days neither House has resolved that it should not be issued then it will be formally published on the GOV.UK website in December 2015.

## B. Answer to consultation questions

**Q1: Do you agree that the government's overarching objectives for charging should be fairness and affordability, environmental protection, stability and predictability and transparency and customer-focused service?**

**Q2: Are there any other comments that you would like to make about the government's overarching objectives for water and sewerage charging set out in Chapter 2?**

There was general agreement from respondents that the government's four overarching objectives for charging were appropriate and important. It was acknowledged that these objectives have underpinned charging policy for many years and felt that they should continue to do so.

While all there was consensus that all of the objectives set out should be a government priority, some respondents suggested extra objectives. One such objective, suggested by several water companies, related to 'resilience'. Respondents recognised that resilience was already mentioned in the draft Charging Guidance under the objective relating to 'environmental protection'. However it was argued that it should be a separate objective because resilience goes beyond only achieving environmental goals and should be included in recognition of the fact that Ofwat is now subject to a resilience duty through the Water Act 14. Another objective suggested was 'the introduction of effective retail and upstream competition', as it was felt that this is sufficiently important to be added as an additional objective.

A further extra objective, suggested by a new entrant, was 'cost reflectivity' to promote effective competition. The correspondent (a prospective new entrant to the retail market) said:

*'cost-reflectivity across the whole value chain is an essential prerequisite of competition; if prices are not set correctly at the wholesale level, there will inevitably be a distortion in competition at the retail level, with margins excessively squeezed for some customers and inflated for others'.*

The desire to see greater mention in the Charging Guidance of all water charges needing to be cost-reflective, or clarification on the topic of cost-reflectivity, was also supported in responses from some incumbent water companies and an inset appointee.

Another topic mentioned commonly in replies was the balance between the four overarching objectives. Many respondents welcomed the government's view that the objectives should have equal weighting and the correct balance between them will need to be determined on a context specific basis. Others, however, wanted to see a prioritisation of the objectives and further guidance to Ofwat on how it should resolve issues which may place these objectives in conflict with one another. A member of the public urged the appropriate emphasis to be given especially to the objective of fairness and affordability when trade-offs are being made.

Respondents also made detailed comments relating to one or more of the overarching objectives:

- Fairness and affordability – One water company commented on that it was difficult to protect certain groups of customers while ensuring there was no undue discrimination and preference in setting charges.
- Environmental protection – An incumbent water company said that they thought the application of universal metering was also an important tool for environmental protection. A customer representative organisation said that customer affordability and acceptability should be part of the evaluation of innovative tariffs.
- Stability and predictability – An incumbent water company pointed out that although stability and predictability is undoubtedly important to customers, it is also important for companies and investors. Another incumbent mentioned that exceptions to the requirements on companies to produce a proportionate impact assessment should be allowed where unavoidable circumstances arise.
- Transparency and customer-focused service - an incumbent water company felt that this objective could have negative consequences if it was interpreted to mean that all components of charges should be published in ways that were not helpful to customers and did not support their ability to make informed choices.

### **Q3: Do you agree with the government's policy priorities for charges schemes for household customers outlined in Chapter 4?**

There was a high level of agreement that the policy priorities set out in Chapter 4 were correct. Several respondents expressed their support for these priorities in their answers and did not make any further remarks.

Others commented on particular parts of the guidance in Chapter 4. One of the areas mentioned in responses was social tariffs. A customer representative organisation saw advantages in industry wide social tariff schemes being funded by the government rather than cross-subsidies from other customers. An incumbent water company also advocated greater standardisation of social tariff schemes across the country. Another incumbent water company, however, had an alternative viewpoint and welcomed the continuation of the current regime. They said:

*'retaining the current (and future) guidance relating to tariffs and charges is a pragmatic decision and we support the ongoing recognition that companies are best place to take decisions on the design of social tariffs.'*

One incumbent water company felt that it should be recognised that social tariffs are not the full extent of a water company's approach to affordability. A member of the public felt that the text on social tariffs did not refer in sufficient detail to vulnerable customers, especially pensioners.

Another topic which received particular mention was Sustainable Drainage Systems (SuDs). Several respondents made comments in general support of the role which these

can play in reducing flooding. A couple of respondents also welcomed the part of the guidance which says that SuDs maintenance costs can be recovered through surface water drainage parts of sewage bills. It was thought that this was a simple and sensible approach.

A third area, which a number of respondents mentioned was transparent and customer focused charging. Several incumbent water companies were of the view that the guidance should not lead to Ofwat's charging rules requiring companies to present charge components to customers at a level over which they don't have control. Highway drainage charges were given as an example of one of these areas. An opposing view on this issue was given, however, by one incumbent water company who strongly supported companies being encouraged to separate out the different elements of charges in customer bills. They added that this is

*'particularly true in the case of Highway Drainage, as this service is provided by all companies for their customers, whereas not all companies provide a separate charge for the provision of this service'.*

Other respondents stressed the importance of bill simplicity.

#### **Q4: What are your views on the guidance on charges schemes for non-household customers provided in Chapter 5?**

Respondents tended to agree with the points and objectives set out in Chapter 5. In particular, respondents agreed that there is a need for Ofwat to recognise the diversity of non-household customers and require companies to provide extra protection for small and micro-businesses. Several water companies with a large rural customer bases particularly welcomed the emphasis on responsibilities toward non-household customers in rural areas. One water company said on both these topics:

*'We welcome the government's clarity on the protection of rural customers and the recognition that many small and medium sized non-households receive domestic-like services and have "more in common with households than larger businesses", including the wholesale costs to serve'.*

Further guidance on how water companies should protect either rural non-households or small and medium sized businesses was requested by several water companies.

A few water companies mentioned that this section of the guidance should make sure that Ofwat's charging rules ensure a level playing field for competition in the new market due to open in April 2017. One respondent wanted to see specific guidance in respect of inset appointees.

A respondent also commented on water companies' charges to maintain fire hydrant. They said that there is inconsistency in these charges by different water companies and they would like to see much less variation between different regions. They also said that there have been unacceptable price increases for this service, especially in London. The respondent felt the government's objectives for charging should extend to charges for these services.



There were a range of views regarding surface water drainage charges and the guidance relating to these. Some respondents expressed their support for non-household charging to be used to encourage the uptake of SuDs or other interventions to prevent flooding. For instance one respondent said:

*'Non-household charging could be an opportunity to encourage private investment into flood alleviation, particularly through the development and maintenance of SuDs. If a company or a group of companies, benefit from an intervention then they should pay toward the intervention.'*

Other respondents strongly disagreed with area-based surface water drainage charging in principle. These respondents were mainly from schools and public sector organisations in the North West of England (see box below). Some water companies also shared the view that there is not a good case to move to area-based surface water drainage charging. On this issue United Utilities commented that meeting policy objectives on fairness was a matter for Defra's guidance to companies and Ofwat and they requested further clarity on eligibility to concessionary schemes. They also noted that any further extension to concessions would impact on customer bills. They estimated, for instance, that including schools in their concessionary scheme could add up to £8 on household bills in their region. A customer representative organisation also noted the potential impact which widening the concessionary scheme could have on other customers' bills and highlighted the need to determine if doing so would be acceptable to customers before any decisions are taken.

**Box 1 - Surface water drainage charging – views from schools and other public sector organisations in the North West of England**

We received a large number of responses on the issue of surface water drainage charges from schools and other public sector organisations located in the North West of England. Respondents participating in this campaign pointed out the difference in levels of surface water drainage charges required across the country. They quoted information from the Department for Education that schools spend £27 million per year on water and sewerage charges in the North West compared to £11 million per year in the South East. As a result of this, they felt that it was very unfair that Ofwat encourages but not requires area-based surface water drainage charging which they attributed to giving rise to the regional differences in charges.

Respondents participating in this campaign wanted schools to be recognised as community assets and therefore be eligible for discounted rates. Alternatively, they wanted the government to provide extra funding to affected organisations.

Respondents also complained that the timing of this consultation coincided with school holidays, which they felt would mean the response was unrepresentative. They also said they were disappointed by engagement on this issue to date.

One water company suggested an alternative to area based charging for surface water drainage in their response. They were of the view that a more appropriate approach would be to identify sites where surface water drainage is causing, or could potentially cause, flooding issues. They suggested that the water companies should prioritise working with customer at such sites to put in place a more sustainable approach to surface water

drainage. They argued that this would remove cross-subsidies for this charging and alleviate flooding issues.

**Q5: Do you think the guidance on charges in relation to the retail market in Chapter 6 will be appropriate for regulating charges when the new retail market for non-household customers opens in April 2017? If not, how could it be improved?**

The general view from respondents was that the guidance in relation to the retail market was broadly appropriate. A water company said:

*'Generally, we think the guidance will be appropriate for regulating retail charges and creating an appropriate market'*

However there was also agreement that the guidance needs to be kept under constant review as the market opens up and becomes established.

There was also strong support for the need for back-stop protections in the new retail market and that these should be provided by default tariffs terms or, alternatively, deemed contracts where a retail exit has taken place. One respondent, however, said that they would welcome more specific guidance on protection for customers in certain areas. Another issue raised on the topic of back-stop protections was the length of these. One respondent was in favour of a minimum length of time for deemed contract protection. A different view, from a water company, was that deemed contract protections should have a maximum length and be time limited.

An issue which was of particular importance to new entrants was retail margins. There was support amongst this group for Ofwat keeping the retail margin under close review. One new entrant wanted the guidance on this issue to be strengthened and for Ofwat to be required to publish details over the tests it had made with regard to this. Another outcome sought by a new entrant was that Ofwat should require wholesalers to publish wholesale charges which are clear and easily understandable to retailers. They said that:

*'We note that for retailers to present the charges to customers simply and transparently, retailers will need to clearly understand the wholesale charges which form the greater part of the non-household bill.'*

Several respondents commented on the section of the guidance which mentioned tariffs and charging standardisation between companies (6.16). The guidance says that there may be some benefits from standardisation of some aspects of tariffs and charging between companies but this would need careful consideration due to potential risks. A new entrant highlighted that the large variation in tariffs and margins across the country presents difficulties for retailers in being able to have a national strategy and provide unified service offerings, suggesting that they would support greater standardisation. An opposite view was also voiced by a water company. They said that standardisation of tariffs would be difficult and warned that it could have unintended consequences; giving rise to substantial incidence effects on customers. Another water company said that any move towards greater standardisation should benefit customers as a whole and be phased in appropriately.

## **Q6: Do you have any comments on the government's proposed approach to upstream reform, as described in Chapter 7, and the high level principles set out here?**

There was support amongst respondents for the phased approach to the implementation of upstream reform set out in the Charging Guidance. Respondents acknowledged that the existing costs principle would need to remain in respect of upstream until an updated framework is in place and thought this approach was appropriate. A water company said:

*'we support the government's approach of introducing upstream reform in a phased evolutionary manner. This will aid stability, and allow plans to be fully thought through and properly implemented'.*

Several water companies also expressed their particular support for the statement in the guidance (section 7.6) that there is no intention to introduce any contestability into the network. An inset appointee also agreed with this position but thought that this should only be beyond the current inset appointment process. Their opinion was that:

*'the downstream costs should be unbundled to develop fair charges to inset appointees which recognise the substitute activities that the inset appoint undertakes in place of the incumbent'.*

Whilst there was support for the government's approach to upstream reform several respondents also noted the potential complexity which the task of setting upstream charges will involve due to the technical and economic issues associated with doing so. There was also some concern that balancing the government's objectives for upstream charges would be difficult since moves to make prices reflect environmental goods could lead to price increases in areas of water scarcity. A customer representative organisation was also concerned that upstream reform could lead to complex tariff structures which might be confusing for customers.

Some respondents also commented on the part of the guidance which relates to charges for bulk transfers water and secondary supplies. One water company said that they would like to see consideration in the guidance around historic bulk water supplies. Another respondent expressed the view that while they see water sharing across boundaries as an important way to balance demand and supply they did not see it as an approach to long term water security.

## **Q7: What are your views on the guidance on charges in relation to developers provided in Chapter 8?**

Overall the responses were positive in relation to the content of chapter 8, and welcoming of the principles within it. Almost half of the respondents commented that they were looking forward to seeing the more detailed guidance. Others commented that they felt more detail was needed, and this detail will follow in the guidance that will be issued under section 144ZD of the Water Act 2014.

Some replies provided suggestions of areas where there should be further detail, including in relation to the different types of charges and what they cover. Infrastructure charges were specifically referred to in several replies.

Improving the transparency of developer charges was a key point picked up by respondents. Many stated that the existing system is poorly understood and that improving transparency will reduce the number of disputes.

Competition in developer connections was raised by several respondents; they also provided details of where they felt that currently competition was being stifled.

One respondent commented that they were disappointed by the lack of guidance on environmental protection.

**Q8: Do you have any other comments about the policy objectives for water and sewerage charging set out in the Charging Guidance?**

**Q9: Is there anything else you would like to add to your response?**

Most respondents did not answer these questions. Of those who did, some used them to express their support for aspects of the guidance. Others reiterated important points which they had raised earlier in their consultation responses. This included concerns from a new entrant organisation about the current wholesale and retail charges and the potential impact they thought these may have on the success of the new competitive retail market. A water company also reiterated views regarding the transparency of charges and how this should only be encouraged where it is helpful.

Others requested further guidance on a range of issues. These included: how the efficient use of wastewater could be encouraged, protections for small or micro businesses in the new retail market, the extent that Ofwat should take CC Water's feedback on a company's charges schemes on board, 'miscellaneous charges' not covered by the four price controls, and the achievement of greater consistency between different regions. Some water companies also mentioned the importance of the timing of the publication of this guidance and stressed that the sooner it was finalised the better.

## C. Government response

The government would like to thank all organisations and individuals for the thoughtful and detailed feedback which we have received in response to this consultation. We welcome the broad-based support for the policy set out in the draft charging guidance to Ofwat. In particular we have noted strong support for the government's four overarching principles, the proposed back stop protections for non-household customers in the new retail market, and the planned phased implementation of upstream reform.

We have considered all the points made in responses carefully and have summarized our views on the main issues raised below.

### Resilience

Several respondents suggested that 'achieving resilience' could be added as another overarching objective, given the importance of this aim and the existence of a new resilience duty on Ofwat. The government welcomes the recognition of the importance of securing the sector's long-term resilience. However, it was not clear how this would be further enhanced through guidance to Ofwat on their Charing Rules. Ofwat's new primary resilience duty applies to their approach to charging as it does to all of their functions.

### Competition

An additional overarching objective suggested was 'effective competition'. Again we strongly share the respondents desire to see a well-functioning competitive market develop in the water industry and acknowledge the important role of charging in securing this. However we do not view this to be suitable as an overarching objective given that these objectives apply across all the charging regimes some of which are not competitive.

### Cost reflectivity

The government notes the comments made relating to cost reflectivity and charging. The government recognises that cost reflective charges can be a useful tool in certain circumstances for achieving specified policy outcomes. For example, cost reflective charging can in some circumstances have beneficial outcomes in terms of incentivising water efficiency. However the structure of this industry around regional monopoly companies does not easily lend itself to driving cost reflectivity across all charging regimes as a desirable outcome in its own right. Indeed, in some circumstances, driving greater cost reflectivity of charges could have detrimental impacts on large groups of customers, such as rural households and businesses (to whom the regulator is required to have particular regard) with no overall policy gain. Water industry charges have always contained a range of cross-subsidies. Unwinding these can have significant incidence effects and should be approached with appropriate caution.

### Transparency

Water company concerns around the potential negative impacts of presenting charges to customers over which they had no influence, and the need for bill simplicity were noted.

The government agrees with the need for charges to be presented to customers in a way which is relevant and easy to understand and viewed the current guidance as consistent with the points made on this issue.

## **Balancing the objectives**

Some respondents wanted further information in the guidance about how water companies should prioritise and balance the different overarching objectives (i.e. fairness and affordability, stability and predictability, environmental protection and transparent and customer-focused charging) if these came into conflict. The government would like to clarify that this guidance is to Ofwat rather than companies. Ofwat, as an independent regulator, has the autonomy to consider the specific circumstances in which their charging rules will be applied.

## **Social tariffs**

Making significant changes to policy on social tariffs (e.g. through devising a national scheme) is out of the scope of this guidance. Since the social tariffs guidance came into force in 2013, 14 water companies have set up social tariffs and the expectation is that all companies will have schemes in place shortly. It's the government's view that water companies are best placed to develop and run these schemes given their in-depth understanding of their local area and their customers' needs. The social tariff guidance will be reviewed on a regular basis in line with regulatory best practice.

We accept that the comment that, since the guidance only mentions social tariffs it could give the impression that this is the only way in which water companies address affordability issues. We have therefore amended our guidance to mention that water companies undertake a wider range of activities to support vulnerable customers.

## **Surface water drainage charging**

The government has reviewed responses relating to surface water drainage charges and acknowledges the strength of feeling on this issue – particularly from schools and public sector organisations in the North West of England. In light of the feedback received, the government has decided to review its Guidance to Water and Sewerage Undertakers in relation to Concessionary Schemes for Community Groups for Surface Water Drainage Charges.

## **Backstop protections in the new retail market**

The government welcomes the strong support for back stop protections for customers in the new retail market. Several respondents requested further guidance on how certain customer groups should be protected (e.g. small and medium sized enterprises). Since the purpose of this Charging Guidance is to set high level principles, doing this is out of the scope of this guidance. It will be for Ofwat to provide charging rules directly to water companies. Ofwat will be issuing customer protection codes for the new market which will provide further information on this topic.

## **Complexity in setting upstream charges**

The government agrees with respondents that setting charges for upstream markets will be a complex matter. Because of this the government is undertaking careful work at present to think through upstream reform. Further detailed guidance on charging in upstream markets will be issued once all the different factors have been worked through with all interested parties. The high-level text in the guidance at present will be built upon once there is greater clarity over the appropriate regulatory framework for the market.

We have taken on board a suggestion by an incumbent water company to rephrase a passage of the guidance on upstream charges (section 7.9). Instead of referring to efficient investment the line now refers to companies being able to finance the proper carrying out of its functions. We agree that this better captures the intended point.

## **Charges for developers**

We are pleased that so many respondents broadly agreed with the principles. A number of respondents referred to the lack of clarity around infrastructure charges. However these are not within the scope of this Charging Guidance. We will take all comments made on this section of the guidance on board when drafting the detailed guidance on charges for developers.

## **Charges not covered in this guidance**

Some respondents pointed to 'miscellaneous' charges (e.g. standpipes, fire authorities and cesspools) not covered by the Charging Guidance at present. These have not been explicitly covered in the guidance since it is the purpose of this document to set high level principles rather than detailed rules on specific charges. It is the role of Ofwat to provide more detailed information on these charges where it deems this necessary. We would, however, expect Ofwat to have regards to the government's overarching principles for water charges (namely fairness and affordability, stability and predictability, environmental protection and transparency and customer-focused charging) when issuing any guidance on these charges, or any others which fall outside of the main charges schemes outlined in the document.